

Attachment 4.

UK CONTRACTORS- PROBLEMS WITH ACCOUNTING FOR WORK-IN-PROGRESS

CASH & ACCOUNTING IRREGULARITIES

There are examples given in my On-Line Report- (www.thinkbigpartnership.com "UK Construction Consolidation 2017-2022" Appendix IV- Historic Competitor Analysis- "Work-In-Progress" pages 54-59).

These examples highlight the major industry problem for contractors associated with "Audit Risk" in valuing Work-in-progress and determining the amount of revenue to be recognised in projects. It requires management to make significant judgements and estimates including the costs to complete, and the identification of any other costs that might arise, the impact of any changes in scope of work, the outcome of disputes with the client over valuation, and the recoverability of Work-in-progress and receivables balances.

Revenue recognition and contract accounting is a significant risk for all contractors. It is an impossible task for external auditors on annual audits to check all project accounts and predict the final cash position on all the yet-to-be completed projects. Management can hide problems leading to false declarations of profits, or understate valuations creating the build-up of reserves. The resultant envelope in valuation of working capital for large contractors can run into tens or even hundreds of millions of pounds.

CASH IS KING IN VALUATIONS

In the Report Appendix mentioned above, some of the key issues/items to watch were listed as:

- Over focus on top-line growth (and more generally EBITDA) at the expense of cash.
- Need to view profit as secured once realised in cash
- Working capital stress through the supply chain leading to businesses taking active steps to resit and/or pass down cash pressure to subcontractors
- Importance of evaluating and managing working capital profile across contract portfolios and tender pipeline
- Pressure on balance sheets to support bonding requirements, and liquidity levels to cope with lumpy cash flows (upfront costs/deferred receipts)
- Absence of a cash culture

CONCLUSION

Management can, and often has knowingly, or unwittingly seriously over-stated profits as a result of inaccurate management accounts associated with on-going projects. Often these errors remain undetected by Annual Audits of accounts.

The difficulty in assessing the true valuation of Work-in-progress has often been viewed as a reason for low levels of M&A in the sector, compared with other sectors, and/or a poison pill for acquisition.